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RUEHRG/AMCONSUL RECIFE 3581
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UNCLAS SECTION 01 OF 04 SAO PAULO 000432

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DEPT FOR WHA/BSC, WHA/EPSC, EB/IFD/OMA
STATE PASS FEDERAL RESERVE BOARD FOR P.ROBITAILLE
STATE PASS TO USTR FOR SCRONIN
STATE PASS EXIMBANK
STATE PASS OPIC FOR MORONESE, NRIVERA, CMERVENNE
NSC FOR FEARS
USDOC FOR 4332/ITA/MAC/WH/OLAC
USDOC FOR 3134/USFCS/OIO
DEPT OF TREASURY FOR JHOEK
PARIS FOR ECON - TOM WHITE
USAID FOR LAC/AA

E.O. 12958: N/A
TAGS: EFIN ECON EINV PGOV BR
SUBJECT: OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC) MEETS WITH CENTRAL BANK AND OTHER BANKING INSTITUTUIONS

SENSITIVE BUT UNCLASSIFIED; PLEASE PROTECT ACCORDINGLY

Summary
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1 (U) The Deputy Comptroller for Global Banking and Financial Analysis, Ms. Nancy Wentzler, and two other OCC economists in the International Banking and Finance department visited Sao Paulo April 25-27 for a series of informational meetings with various financial sector economists and bankers in Sao Paulo. They were joined by the new regional Treasury Representative in Sao Paulo, William Block, and Econoff. In addition to Central Bank representatives, they met with Banco Santander, Banco Itau, Banespa, Citigroup, JP Morgan, Lehman Brothers, Maua Investments, Nossa Caixa Bank, and Unibanco.

¶2. (U) The current local mood about Brazil's near and medium-term prospects is almost uniformly positive. In contrast to more cautiously optimistic views heard during previous meetings here (September 2006), current sentiment is much more upbeat. Most growth forecasts have been revised upward in recent months by 50 basis points (4.0-4.5 percent projected growth in 2007). Domestic demand is improving, trade performance is solid, and net financial inflows have accelerated. Continued foreign exchange appreciation (USD 1.90-1.95 from USD 2.00-2.05 at end-April) is forecast for ¶2007. Brazil's Emerging Markets Bond Index (EMBI) spread is only 20-30 basis points above Mexico's despite Brazil's being two notches below investment grade (upgraded since this visit by Fitch and S&P). Falling interest rates have supported credit growth, capacity utilization, and increased fiscal policy space. A financial crisis - domestic or external - in the next 3-5 years is difficult to

imagine. End Summary.

SOURCES OF BRAZIL'S IMPROVEMENT

Disinflation

¶3. (U) In the view of virtually all market participants, disinflation has been the most important factor contributing to the improvement in Brazil's performance in recent years. Low and stable inflation is now perceived to be a largely permanent feature of Brazil's economy and, as one analyst stated, "has made Brazil a normal country for the first time in its history." Stable inflation expectations have reduced Brazil's country risk premium and cost of capital, allowed investors to project cash flows over much longer time horizons (5-10 years), reduced dead-weight loss associated with unstable prices, and helped extend Brazil's term structure out to more than 10 years in BRL denominated instruments. Brazil's central bank is the most respected economic institution in the country.

Reserve Accumulation

¶4. (U) The pace of reserve growth accelerated sharply in the first quarter of 2007. The current stock of reserves (around USD 120 billion at end-April, and subsequently higher by an additional USD 5-10 billion) has helped eliminate net public external debt and significantly reduced Brazil's exchange rate vulnerability. Most analysts believe considerable room remains to build reserves further in 2007-08. Few if any concerns were expressed about the potential costs of continued reserve growth - for example, the quasi-fiscal costs of rising sterilization (offset in part by falling interest rates) or rising inflation (offset by stable inflation expectations and rising real money demand). The quality of recent financial

inflows is seen as high, with net foreign direct investment inflows (in part resulting from rising IPO activity) comprising a large share of inflows. High local yields and stable foreign exchange expectations have encouraged global carry-trade inflows. The private banking system maintains a net long position in Brazilian currency.

Rising Private Sector Productivity

¶5. (U) Although productivity figures are scarce and subject to significant standard error, the consensus view is that Brazil's private sector is experiencing rapid productivity and investment growth despite high bureaucratic costs and weak business climate indicators. In contrast to most other Latin American countries (for example, Mexico), Brazil's private sector is seen as highly dynamic and globally competitive. Growth sectors include energy, agri-business, construction, and financial services. With key micro-level reforms, Brazil's private sector is poised for rapid and sustained growth.

Banking System Strength

¶6. (U) Bank balance sheets are strong (average 16 percent capitalization, legal minimum of 11 percent), and banks should experience rapid growth in coming years (real estate, medium-sized commercial lending). Credit growth (consumer and commercial lending) has expanded rapidly (Citibank has doubled its employees in its consumer lending department in the past 12 months). Many analysts noted growth opportunities in housing finance (now only 1.5 percent of GDP), though legal reforms (for example, implementation of a recent bankruptcy law) are needed first to catalyze lending. Payroll lending to public sector employees (monthly income serves as underlying collateral) has risen sharply. A small enterprise loan market exists but is hobbled by high delinquency (average 1.5 percent default rate per month) and the absence of adequate credit rating information. Local derivative markets are adequate for most hedging purposes, with swaps available at reasonable cost and duration. The quality of bank supervision is reported to be high. Implementation of Basel II will begin in 2008.

Low Political Risk

¶7. (SBU) Political risk is low and fears of Latin-style populism in Brazil have largely disappeared. Most Brazilians view Venezuela and Bolivia as risks, not benefits, for Brazil and want to avoid alignment with both countries. The parameters of economic policy debate in Brazil have narrowed considerably in recent years. Even among bankers, Lula is well regarded - not because of what he has accomplished but because of what he has avoided, which is inflation. One banker stated that Lula "is the most pragmatic person in the world, and doesn't have an ideological bone in his body." Another stated that Lula will be recorded as one of Brazil's greatest presidents because he has "discredited populism in Brazil." At the same time, all analysts agreed that prospects for economic reform are non-existent under Lula, and are looking to 2010 as the next reform window.

CHALLENGES AND PRIORITIES

Poor Fiscal Performance

¶8. (SBU) Despite continued strong headline numbers, Brazil's fiscal framework and the underlying quality of its fiscal performance are

seen as weak. Problems most commonly cited were: (a) poor quality of public sector expenditures and the lack of social returns earned on public spending; (b) high tax rates (around 35 percent average rate) and complexity, which increase evasion and add to economy-wide dead weight loss; and (c) continued growth in expenditure indexation. Unwinding indexation, especially with pensions, is essential but will be politically difficult. Because of low public sector expenditure quality, Brazilian firms and individuals must absorb many additional health and educational costs, effectively increasing the tax rate. Modest tax reform is seen as possible before 2010. Pension reform, however, will require more time.

Financial Sector Reforms

¶9. (U) Despite a reasonably robust and healthy banking system, problems most frequently cited included: (a) a large financial sector bureaucracy that imposes high red-tape costs, (b) the absence of securitized and syndicated loan markets (for example, an MBS market barely exists), and c) weak and costly foreclosure procedures that contribute to high loan-deposit spreads. Until loan recovery rates improve, unsecuritized lending is unlikely to grow. The average monthly interest rate for small-sized enterprise lending is reportedly 5-7 percent.

Costly Labor Markets

¶10. (SBU) The high cost of firing employees is seen as a significant barrier. One analyst stated that it is "virtually impossible to fire anybody in Brazil." High costs discourage future employment growth, decrease labor market mobility, reduce resources available for capital spending, and push a large number of employees into the informal sector (around 35 percent of GDP). There are no expectations of labor market reform under Lula.

Energy Sector

¶11. (U) Several analysts noted emerging weaknesses in Brazil's energy infrastructure and rising vulnerability to an energy shock. Brazil remains highly dependent on rainfall to generate electricity. Brazil's government is responding by increasing capacity, though too slowly. Private investment is discouraged both by formal barriers and by a rigid retail price regime. Even absent a shock, a supply-demand imbalance is expected to emerge by 2010 and become a growing supply-side constraint.

ISSUES FOR FURTHER EXPLORATION

Intensity of Bank Competition

¶12. (U) Although most analysts believe Brazilian banks do compete against each other, a consistent view was not provided about why abnormally high profits in the sector (recent annual Return-on-Equities of 30 percent) are not increasing existing competition or attracting new entrants. Brazil's banking system is fairly concentrated; 5-6 banks hold two-thirds of deposits and many banks have quasi-monopolistic holds in some lending markets. Some believe the lack of competition is due to regulatory barriers (for example, the time and paperwork involved when consumers try to transfer accounts to different banks, which reduces bank competition), while others believe that further capital market deepening is needed to increase the level of competition banks face.

Economic Openness

¶13. (U) Views also differed on the extent to which Brazil is externally open. While formal trade barriers have fallen, informal barriers remain high. A recently established "IPOD Index" (akin to the Big Mac index of The Economist news magazine, measuring relative prices of non-tradables across countries) that attempts to proxy the international price of tradable goods reportedly showed that Brazil has the highest IPOD costs of any country in the world, thus suggesting a lack of openness.

Reducing Real Interest Rates

¶14. (U) Some analysts believe that further reductions in real rates (currently around 8.5 percent) are needed for higher growth. Others, however, believe that lower rates, while beneficial, will have a smaller impact on growth. One reason cited is that Brazil is already thought to be growing at or near its full employment level (i.e., reducing the output effects and increasing the price effects of further monetary stimulus). Some analysts also noted that lower rates may further diminish Lula's political incentive to enact reforms by providing him with further breathing room with fiscal policy.

Central Bank Foreign Exchange Intervention

¶15. (U) Most analysts believe recent central bank reserve growth is motivated by its interest in increasing precautionary reserves. However, at least one major bank (Unibanco) stated that intervention is being driven primarily by a need to prevent excessive currency appreciation and pre-empt export-industry political pressures.

Benefits of Investment Grade Status

¶16. (U) Views also differed on the expected benefits of investment grade status. Some analysts believe this will be an important milestone and will generate important spinoff benefits (for example, further investment from institutional investors). Others noted that Brazil's external, dollar-denominated debt is already trading close to investment grade spreads and do not foresee significant additional benefits. As a result of Brazil's recent GDP revision and reduced debt ratios, investment grade status is now expected by the end of 2009 rather than 2010.

¶17. (U) This cable was coordinated with Embassy Brasilia.

MCMULLEN